Atkins Bland

Investments • Pensions • Financial Planning

Guide to:

Forecasting Future Retirement Income

Introduction

Why we made this guide

Trying to estimate how much retirement income we can expect, and what we need to do to increase it to a specified target, is normally a central part of sensible pre-retirement financial planning.

It is also, therefore, a subject where Atkins Bland offers more than one guide, looking at different aspects.

The purpose of this guide is to provide a very general overview of some core considerations in terms of assumptions to make, especially with regards how money invested now may grow in value, prior to being needed for retirement income.

Pension and investment company illustrations structured in line with FCA requirements can also be helpful and are important for disclosure and assessment of the impact of costs and charges. They also help when comparing one plan with another. However, when looking holistically at overall retirement income we feel a simpler approach is more suitable. After all, any forecast of unknown future factors is almost guaranteed to prove wrong, so there is no real benefit in making it overly complex.

How to start: with a target

The first thing to establish is how much you expect to be spending in retirement. We cannot possibly know that in £ terms as we don't know what future inflation will be, so the best option is to assess it in today's values.

A good way to do this is to look at current spending, deduct anything likely to have stopped by retirement (such as mortgage payments and the cost of raising children) and add items which might increase, such as extra spending on holidays and other leisure pursuits.

How to assess what income may be available

The starting point for this is to look at the current value of existing assets earmarked for eventual retirement income.

Next, we can look at what additional resources are expected to be built up from future savings, future accrual in an employer's pension plan or anticipated future capital receipts.

This gives us the universe, in today's values, of expected resources at retirement.

Introduction

Why we made this guide

How to adjust for inflation

This is easy with the cost of living since it should broadly keep in line, so no adjustment is needed.

With invested assets, a common approach is to assume a future rate of inflation and many projections of retirement income, including illustrations produced by pension providers using the structure prescribed by the FCA, do just that.

They then normally use another set of assumptions for future investment returns and seek to estimate a 'real' return by deducting the first assumption from the second.

However, a simple wander through history shows that inflation rates have changed massively over time, and are not easy to control, so using a specific figure as an assumption adds a good deal of risk of proving wildly wrong.

If you then also remember that investment growth has varied hugely over time, and between different types of investment, it's clear that using numerical assumptions to predict the future real value of invested capital has deep flaws in its usefulness.

In our opinion, a more suitable assumption is to simply work on the basis that the value of capital, assuming it is suitably invested for the medium to long term, will keep pace with inflation, rather than outstrip it.

It is possible that this will prove over-optimistic, but assuming invested resources keep pace with inflation and do nothing more is erring on the cautious side, based on the historic records for most investments suited for longer term capital, so the main risk is of underestimating future values, rather than overestimating them.

Underestimating is fine, as it can lead to pleasant surprises, while overestimating can lead to unpleasant ones, so is not a good outcome.

Therefore, our solution to the dilemma of accounting for inflation and investment growth in projections of future values is very simple and straightforward; we work with current values and assume they will increase in value in line with inflation.

However, not every asset is the same and we set out below some notes regarding the main sources of retirement income, in terms of the probability of their underperforming or outstripping inflation.

Forecasting future income

Methods of income generation to provide an income later in life

The State Pension

The State Pension enjoys the triple lock, whereby it rises by a minimum of 2.5% p.a., the change in the Consumer Price Index (CPI) or Average Earnings, whichever is higher.

The longevity of the triple lock is questionable, as having a numeric figure in there makes little sense. If inflation averaged 1% or less for a few years, the 2.5% minimum would start to look irrational.

However, even without that, we can be fairly confident the State Pension will keep pace with the rising cost of living, as long as the CPI remains a valid measure of this.

While the triple lock is in place, there is a decent chance the State Pension will increase by more than inflation, thus mitigating some of the risk of other sources of income failing to do so.

Current employer defined benefit pensions

These are normally linked to actual salary or career average salary.

The longer term past trend has been for salaries to rise ahead of inflation over the longer term, but that cannot be relied upon. It is, though, unlikely that they will drop behind inflation, so assuming they keep pace is a reasonable assumption.

Deferred employer defined benefit pensions and pensions in payment

These are normally linked to inflation to some degree.

Government versions usually have no cap on increases, while the private sector, without such deep pockets as they don't have the taxpayer to bail them out, usually cap the inflation linking at either 2.5% or 5% p.a.

Private sector pensions do, therefore, carry some risk of falling behind inflation were it to rise above the cap imposed. However, for the sake of a future projection, it is reasonable to assume a defined benefit pension will combat inflation.

Capital already invested and earmarked for retirement

The probability of this retaining its real value against inflation pivots on how it is invested. However, any investment strategy suited to building up resources over the medium to long term, to be used for income generation in retirement, should have inflation protection as a minimum objective. It may not achieve it, but it is reasonable to assume that it will, on average, over the years.

Indeed, it is reasonable to assume it should outstrip inflation based on past records, so assuming it does no more than match inflation is conservative and builds in some prospect of the pleasant surprise referred to earlier.

Rental income

This inevitably varies depending on periods of non-occupancy and refurbishment and other expenses. However, it is reasonable to assume that, over the longer term, rental profits should keep pace with inflation.

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Capital on deposit in savings accounts or similar

This may keep pace with inflation if future interest rates are high enough and interest is left in the account. However, this is not a realistic expectation and it is best to assume that any capital to be retained on deposit will not be available for the generation of regular retirement income.

If any does remain in place at retirement and can be redeployed into investments suited to providing retirement income, that can be treated as a bonus, but we would not normally build this into a future projection.

Future savings

This will depend on how the money is invested, but if it is earmarked for building up resources to generate retirement income it should be allocated in a way that has a realistic prospect of at least keeping up with inflation.

We will, therefore, normally assume it does so but, as with money already invested, does not do more than that.

This should, therefore, be a conservative assumption and help mitigate the risk of disappointment.

A potential inheritance

In most cases neither the value nor timing of a possible inheritance can be predicted, so this is best disregarded from projections.

However, there can be exceptions and we will always be mindful of that in our analysis.

Potential capital release from property downsizing

The merits of taking this into account in an estimate of retirement income will depend on individual circumstances. In most cases it is probably best to exclude this potential capital and treat any released this way as possible rather than reliable.

However, if it is realistic to consider this a reliable source of retirement income, we can include it in our projections, based on an assumption that property values keep pace with inflation.

Using capital to buy an annuity

While we can apply the same assumptions as set out above in terms of the value available, it is impossible to predict what future annuity rates may be. However, as they are currently near to an all-time low, due to their linking to interest rates, it is reasonable to work with current rates.

They may, of course, fall further, especially if there is a major medical breakthrough which significantly increases average life expectancy, but, with the caveat that any assumptions applied to the future have inbuilt uncertainty, we feel using current rates is a reasonable approach.

A worked example

How forecasting income might look in an everyday situation

Jack, born 21st March 1971 and Jill, born 18th January 1973.

Jack, self-employed, is paying into a personal pension. The plan is worth £200,000 and he pays in £300 p.m.

Jill, a teacher, is in the Teachers' Pension scheme.

Estimated joint net income required in retirement, in today's terms: £36,000 p.a. or £3,000 p.m.

Both are hoping to retire at age 65.

They jointly own a rental property with typical profits of £8,000 p.a.

They have stocks & shares ISAs worth £30,000 each.

Source	Estimated gross amount p.a. In today's terms	Notes
Jack's State Pension	£9,340	This is the basic rounded up for 2021/22 tax year. Payable from age 67
Jill's State Pension	£9,340	As above
Jack's deferred benefits in the ABC Pension Scheme	£3,000	Revalued to today, inflation protected up to 5% p.a. Payable from age 65.
Jill's Teacher's Pension	£4,000	Accrued to date. Projected if remains in scheme until 65, £12,000 p.a. Inflation protected up to 5% p.a.
Pension funds at current values	£6,000	Assuming 3%* is withdrawn as a sustainable lifetime payment which can combat inflation
Jack's non pension investments (ISA)	£900	As above
Jill's non pension investments (ISA)	£900	As above
Potential extra income from future savings	£1,620	Based on £300 p.m. for 15 years (£54,000) and assuming 3%* p.a. is available as income. As we are using current values, this assumes Jack increases the pension payments by inflation every year.
Jack's rental profit	£4,000	Will vary with costs and occupancy
Jill's rental profit	£4,000	As above

**The figure we use here will depend on individual preferences over how capital is invested. We try to be realistic but conservative, based on past records, prevailing conditions and reasonable assumptions for the future. However, there is clearly a potential for any estimate to prove optimistic once we have the benefit of hindsight.*

A worked example

How forecasting income might look in an everyday situation

The total estimated **net** annual income from the above, based on the assumptions used and current tax rules is:

Jack's, gross but taxable

State Pension:	£9,340
Former employer's pension:	£3,000
Personal pension:	£7,620
Rent:	£4,000
Subtotal:	£23,960
Net based on current tax rates:	£21,682
Add tax free income from ISA:	£900
Total	**£22,582**

Jill's, gross but taxable

State Pension:	£9,340
Teachers' pension accrued:	£4,000
Potential further Teachers' pension:	£8,000
Rent:	£4,000
Subtotal:	£25,340
Net based on current tax rates:	£22,786
Add tax free income from ISA:	£900
Total	**£23,686**

In an actual situation, we would then look at the impact of their retiring two years before the State Pension starts, assess the impact if Jill left her current employment so did not accrue further benefits in the Teachers' Pension Scheme and also look at the impact if one were to pass away, either before or after retirement.

However, our purpose here is just to show our methodology, and explain the thinking behind it, particularly in the way we deal with the unknowns of future inflation and future investment returns.

Other guides

Our other guides looking at the subject of retirement income

These are listed below and available on request:

- **Guide to Investing for Income**
  This looks at the general subject of what investment options are available and the core features of each.

- **Guide to Investment Income Yields**
  This looks at current income available from different types of investment.

- **Guide to Generating Income from Natural Yield**
  This discusses the benefits of using actual income rather than spending capital as income.

- **Guide to Sustainable Income and Capital Drawdown in Retirement**
  This looks at the subject of how much 'income' may be sustainable throughout life from a capital sum, where someone is prepared to spend both the income and the capital itself.

- **Guide to the Risks of Future Yield Compression**
  This looks at the additional uncertainties associated with trying to estimate how much income might be available from capital not yet available, but expected to be so in the future.

- **Guide to our Assumptions for Future Investment Values**
  This topic is covered in this guide too, but we have a separate shorter guide looking at just this issue.

Important notes

Any opinions expressed on the merits or disadvantages of any options are intended as a general comment only and not as specific advice to the reader.

This document is intended as a supplement to full independent advice and not as a replacement for it and should be read in conjunction with any personalised recommendations provided by Atkins Bland Ltd and with any product brochures supplied.

The value of investments will fall as well as rise, as can any income produced.

Inflation can reduce the real value of capital and the income it generates.

Past investment performance is not a reliable guide to the future.

Any reference to taxation, regulation or legislation is based on our current understanding and details should be checked before any reliance is placed upon its accuracy.

The impact of taxation and tax planning depends on individual circumstances and may be subject to change, which can be retrospective.

Errors and omission excepted.

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The value of most investments will fall as well as rise, as can any income generated. An investor may, therefore, get back less than invested.